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By Chris M. Goodrich*

Recent Developments in the Hospital Shared-Service Organization Controversy†

I. INTRODUCTION

For several years, the health care industry has been struggling to minimize the highly publicized rise in health care costs. Early in this struggle, it was determined that hospitals could reduce their costs of operation by forming cooperative organizations to perform various supportive services, such as laundry, purchasing, and data processing. Such organizations typically perform only one or a few specialized services for their member hospitals who, in return, share the costs of the organization. Although much of the savings generated by such hospital service organizations come as a result of economies of scale, preserving these savings is often dependent upon the organization's ability to secure tax-exempt status.

Despite this need for tax-exempt status, and despite the increasing number of hospital service organizations which are being established in an effort to contain costs, the tax status of such organizations remains an area of controversy and confusion. The source of the problem is the Internal Revenue Service (IRS) which continually resists the granting of tax-exempt status to many hospital service organizations.

II. RECENT DEVELOPMENTS

Until recently, the controversy involving hospital service organizations had been confined to federal district courts and the Court of Claims.¹ However, the Tax Court and the Third and Ninth

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† The author wishes to gratefully acknowledge the help of his friend and colleague, Patricia A. Zieg, in reviewing the drafts of this article.

1. See *Northern Cal. Cent. Serv., Inc. v. United States*, 591 F.2d 620 (Ct. Cl. 1979); *Chart, Inc. v. United States*, 491 F. Supp. 10 (D.D.C. 1979); *Community Hosp.*

Circuit Courts of Appeals have now entered the controversy in *Associated Hospital Services, Inc. v. Commissioner*,² *HCSC-Laundry v. United States*,³ and *Hospital Central Services Association v. United States*,⁴ respectively. The facts of these recent cases are neither unique nor complex when compared with the other cases concerning hospital service organizations.

In *Associated Hospital*, a nonprofit corporation provided a "bacteria-free" laundry service to its member hospitals, all of which were tax-exempt and were unable to get the services through the commercial laundries in their vicinity. The nonprofit corporation was controlled by its member hospitals and was operated in such a way that little or no net income was realized.

HCSC-Laundry involved a nonprofit corporation whose sole activity was providing laundry and linen services to member nonprofit hospitals and nonprofit volunteer ambulance services. All of the members had tax-exempt status. The nonprofit corporation realized no net income from its operations.

Similarly, *Hospital Central Services* involved a nonprofit corporation which was formed by tax-exempt hospitals to perform the sole function of providing highly-sanitized laundry services to the members of the corporation. The nonprofit corporation only charged its member hospitals an amount which was sufficient to meet its annual operating expenses.

III. THE ISSUES

The hospital service organization controversy has primarily involved two arguments. In *Associated Hospital*, *HCSC-Laundry*, and *Hospital Central Services*, the IRS asserted the same two arguments to the Courts of Appeal and the Tax Court as it had asserted to the federal district courts and the Court of Claims in earlier cases.⁵ The IRS first argued that hospital service organiza-

Serv., Inc. v. United States, 43 A.F.T.R.2d (P-H) 79-934 (E.D. Mich. 1979), *appeal docketed*, No. 79-1286 (6th Cir. May 29, 1979); *HCSC-Laundry v. United States*, 473 F. Supp. 250 (E.D. Pa. 1979), *rev'd*, 624 F.2d 428 (3d Cir. 1980); *Metropolitan Detroit Area Hosp. Serv., Inc. v. United States*, 445 F. Supp. 857 (E.D. Mich. 1978), *appeal docketed*, No. 78-1205 (6th Cir. May 25, 1978) and No. 78-1218 (6th Cir. June 7, 1978); *Hospital Cent. Serv. Assoc. v. United States*, 40 A.F.T.R.2d (P-H) 77-5646 (W.D. Wash. 1977), *rev'd*, 623 F.2d 611 (9th Cir. 1980); *United Hosp. Serv., Inc. v. United States*, 384 F. Supp. 776 (S.D. Ind. 1974); *Hospital Bureau of Standards & Supplies, Inc. v. United States*, 158 F. Supp. 560 (Ct. Cl. 1958).

2. [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17.

3. 624 F.2d 428 (3d Cir. 1980), *rev'g*., 473 F. Supp. 270 (E.D. Pa. 1979).

4. 623 F.2d 611 (9th Cir. 1980), *rev'g*., 40 A.F.T.R.2d (P-H) 77-5646 (W.D. Wash. 1977).

5. See note 1 *supra*.

tions were not entitled to tax-exempt status because they did not fall within the safe-harbor of section 501(e) of the Internal Revenue Code,⁶ a specific provision dealing with the tax exemption of hospital service organizations ("the section 501(c)(3) argument"). The hospital service organizations' response, typical of the counter-argument made in the previous cases, was that they are entitled to tax-exempt status under section 501(c)(3),⁷ the general exemption provision for charitable organizations, and that they did not need to rely on section 501(e). It is the position of the IRS that section 501(e) is the only provision of the Code which grants exempt status to hospital service organizations and that section 501(c)(3) is not applicable.

The second argument made by the IRS was that the hospital

6. Section 501(e) provides in pertinent part as follows:

(e) Cooperative hospital service organizations.—For purposes of this title, an organization shall be treated as an organization organized and operated exclusively for charitable purposes, if—

(1) such organization is organized and operated solely—

(A) to perform, on a centralized basis, one or more of the following services which, if performed on its own behalf by a hospital which is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption: data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services.

I.R.C. § 501(e).

7. Section 501(c)(3) provides in pertinent part as follows:

§ 501. Exemption from tax on corporations, certain trusts, etc.

(a) Exemption from taxation.—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under Section 502 or 503.

(c) List of exempt organizations.—The following organizations are referred to in subsection (a):

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

I.R.C. § 501.

service organizations were also not entitled to tax-exempt status because they were "feeder" organizations within the meaning of section 502(a),⁸ the provision of the Code that denies tax-exempt status to organizations which are run "for profit" and which contribute their profits to tax-exempt organizations ("the section 502 argument"). The typical response of the hospital service organizations to the section 502 argument was that section 502 was not applicable since (1) they were not run "for profit", and (2) they were each an integral part of the exempt activities of their member hospitals.

Previously, the federal district courts and the Court of Claims had rejected both the section 501(c)(3) argument and the section 502 argument made by the IRS, and had granted tax-exempt status to hospital service organizations. But recently, the Tax Court, in *Associated Hospital*, accepted the IRS's section 502 argument.⁹ Additionally, the Third and Ninth Circuits, in *HCSC-Laundry*¹⁰ and *Hospital Central Services*,¹¹ respectively, accepted the IRS's section 501(c)(3) argument.

In *Associated Hospital*, the Tax Court, in accepting the section 502 argument, held that the hospital service organization was a feeder organization which was ineligible for tax-exempt status; however, the Tax Court did not address the section 501(c)(3) argument. Unlike the Tax Court, the Third and Ninth Circuits took a position on the section 501(c)(3) argument and held that section 501(e) pre-empted the applicability of section 501(c)(3) to hospital service organizations. However, the Third and Ninth Circuits did not take a position on the section 502 argument. Thus, the Tax Court and the Courts of Appeal addressed different issues in the hospital service organization controversy, but none of the courts addressed both issues.

Inasmuch as the Tax Court, the Third Circuit and the Ninth Circuit have taken positions adverse to that taken in six other jurisdictions, the recent decisions in *Associated Hospital*, *HCSC-Laundry*, and *Hospital Central Services* warrant close review. This is particularly true since they may have an impact on those appeals currently pending in the Sixth Circuit.¹² Indeed, the Ninth

8. Section 502(a) provides: "(a) General Rule.—An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501." I.R.C. § 502(a).

9. [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17.

10. 624 F.2d 428 (3d Cir. 1980).

11. 623 F.2d 611 (9th Cir. 1980).

12. See *Community Hosp. Serv., Inc. v. United States*, 43 A.F.T.R.2d (P-H) 79-934 (E.D. Mich. 1979), appeal docketed, No. 79-1286 (6th Cir. May 29, 1979); *Metro-*

Circuit based its decision in *Hospital Central Services* entirely upon the precedent set by the Third Circuit's *HCSC-Laundry* decision.¹³

A. The Section 502 Argument and *Associated Hospital*

1. The Validity of the Section 502 Regulations

a. The Background of the Section 502 Regulations

As noted by the Tax Court at the outset of its *Associated Hospital* decision, "[t]he tax history of hospital service organizations, and laundry service organizations in particular, is a long and stormy one."¹⁴ Accordingly, before analyzing the Tax Court's application of section 502 in *Associated Hospital*, a brief review of section 502 would be in order.

Prior to the enactment of section 502's predecessors, a number of commercial organizations were held to be tax-exempt organizations merely because they paid all their profits over to an exempt organization.¹⁵ This raised a feeling that a tax exemption gave to tax-exempt organizations an unfair economic advantage in competing with taxable businesses.¹⁶ The Revenue Act of 1950 sought to eliminate this unfair advantage by removing the tax exemption available to businesses whose activities were unrelated to charity, but whose profits were turned over to charities. Such businesses became known as "feeder" organizations. Perhaps the most striking example of a feeder organization involved New York University School of Law's ownership of the nation's then largest noodle manufacturer.¹⁷ In what is now section 502, a feeder organization, which is denied tax-exempt status, is defined as an "organization operated for the primary purpose of carrying on a trade or business for profit" which pays all of its profits to an exempt organization.¹⁸

After the enactment of section 502's predecessor, section 39.101-2(b) of Regulation 117 was adopted by the Treasury Department. Section 39.101-2(b) was carried over after the enactment of the 1954 Code to become Treasury Regulation section 1.502-1(b). This regu-

politan Detroit Area Hosp. Serv. v. United States, 445 F. Supp. 857 (E.D. Mich. 1978), *appeal docketed*, No. 78-1205 (6th Cir. May 25, 1978) and No. 78-1218 (6th Cir. June 7, 1978).

13. 623 F.2d 611 (9th Cir. 1980), *rev'g*, 40 A.F.T.R.2d (P-H) 77-5646 (W.D. Wash. 1977).

14. [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 118.

15. *See, e.g.*, C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3d Cir. 1951); Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938).

16. 96 CONG. REC. 13273 (1950); S. REP. NO. 2375, 81st Cong., 2d Sess. 28-29 (1951).

17. *See* C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3d Cir. 1951).

18. I.R.C. § 502(a).

lation attempts to clarify, by example, when an organization related to a tax-exempt organization can itself qualify for tax-exempt status. This regulation reads as follows:

[Example 1] If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an *integral part of the exempt activities* of the parent organization, its exemption would not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. [Example 2] However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. [Example 3] *Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.*¹⁹

It is the third example of the above-quoted regulation which is the basis of the IRS's section 502 argument. The IRS contends that hospital service organizations organized in a manner similar to that involved in *Associated Hospital* fall within the meaning of this third example.

b. *The Hospital Bureau Case*

Prior to *Associated Hospital*, a hospital service organization had successfully challenged an IRS application of the third example, and thereby precluded its being characterized as a feeder organization.²⁰ The taxpayer in the *Hospital Bureau* case was a corporation formed to evaluate and purchase the necessary hospital supplies for its members who were tax-exempt, charitable hospitals. The government took the position that the corporation was not entitled to tax-exempt status. However, the Court of Claims held that the cooperative purchasing corporation was itself an exempt organization because it was not an "organization operated for the primary purpose of carrying on a trade or business for profit."²¹ Instead, the corporation in question was found to have been en-

19. Treas. Reg. § 1.502-1(b) (1980) (emphasis added).

20. See *Hospital Bureau of Standards & Supplies, Inc. v. United States*, 158 F. Supp. 560 (Ct. Cl. 1958).

21. *Id.* at 563.

gaged in a business enterprise which bore a close relationship to the functioning of the tax-exempt hospitals and was an "integral part of the operation of its hospital members."²² The *Hospital Bureau* decision is now the leading case in the hospital service organization controversy.

c. Congressional Response to IRS Tenacity—Section 501(e)

Despite the Court of Claims' decision in *Hospital Bureau*, the IRS held to its position that if two or more exempt hospitals joined together and created an entity to perform services for the hospitals, the entity is not tax-exempt.²³

In an effort to change the position taken by the IRS, Congress, in 1968, enacted section 501(e) of the Code.²⁴ Section 501(e) provides that cooperative hospital service organizations will qualify for exemption if they perform one of the following services: data processing, purchasing, warehousing, billing and collection, food, industrial engineering, laboratory, printing, communications, record center and personnel.²⁵

The enactment of section 501(e) did not stay the controversy involving hospital service organizations. The Service's position as to the applicability of section 502 remains the same for those hospital services organizations which provide services other than those specified in section 501(e). Despite its persistence, the IRS's section 502 argument, prior to *Associated Hospital*, had been consistently rejected by courts.²⁶ The basic rationale of the courts was that section 502 was not applicable because hospital service organizations are not profit-making ventures.

d. Associated Hospital—A Break with Precedent

Contrary to the decisions of other courts, in *Associated Hospi-*

22. *Id.* at 562.

23. See T.D. 6662, 1963-2 C.B. 214, which amended Treas. Reg. § 1.502-1(b) to limit the concept of related organizations to a parent-subsidiary relationship. See also, S. REP. NO. 744, 90th Cong., 1st Sess. 200 (1967).

24. Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 109, 82 Stat. 251 (1968) (current version at I.R.C. § 501(e)).

25. I.R.C. § 501(e).

26. See *Northern Cal. Cent. Serv., Inc. v. United States*, 591 F.2d 620 (Ct. Cl. 1979); *Community Hosp. Serv., Inc. v. United States*, 43 A.F.T.R.2d (P-H) 79-934 (E.D. Mich. 1979), *appeal docketed*, No. 79-1286 (6th Cir. May 29, 1979); *HCSC-Laundry v. United States*, 473 F. Supp. 250 (E.D. Pa. 1979), *rev'd*, 624 F.2d 428 (3d Cir. 1980); *Metropolitan Detroit Area Hosp. Serv., Inc. v. United States*, 445 F. Supp. 857 (E.D. Mich. 1978), *appeal docketed*, No. 78-1205 (6th Cir. May 25, 1978) and No. 78-1218 (6th Cir. June 7, 1978); *Hospital Cent. Serv. Assoc. v. United States*, 40 A.F.T.R.2d (P-H) 77-5646 (W.D. Wash. 1977), *rev'd*, 623 F.2d 611 (9th Cir. 1980); *United Hosp. Serv., Inc. v. United States*, 384 F. Supp. 776 (S.D. Ind. 1974).

tal, the Tax Court held that hospital service organizations, which provide services not listed in section 501(e), are subject to the prohibition of section 502 by virtue of the regulations promulgated thereunder, more specifically the third example expressed in Regulation section 1.502-1(b), quoted above.²⁷ The Tax Court reached this holding despite the fact that it seriously questioned the original validity of the regulation's third example.²⁸ However, the Tax Court upheld the regulation on the basis of the Reenactment Doctrine.

The so-called Reenactment Doctrine was first enunciated in *Helvering v. Winnmill*,²⁹ as follows: "[t]reasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."³⁰ The Tax Court felt compelled to apply the Reenactment Doctrine in *Associated Hospital* (which involved a hospital service organization which only rendered laundry services) since Congress had on two occasions, in 1968 and 1976, clearly decided not to make laundry services an exempt activity under section 501(e).³¹

The Tax Court's application of the Reenactment Doctrine is troublesome for two reasons. First, the majority overlooks the fact that, at the same time Congress was discussing laundry services, it also recognized and approved of the leading case granting section 501(c)(3) exemption to hospital service organizations.³² It is certainly arguable that Congress viewed the *Hospital Bureau* decision as protecting hospital service organizations from being characterized as feeder organizations under section 502.³³ This argument is further bolstered by the fact that Congress chose to enact a special provision (section 501(e)) to help protect hospital service organizations.

Second, the legislative history relating to the enactment of section 501(e), which evolved subsequent to *Hospital Bureau*, does not discuss laundry services in the context of section 502, but rather in the context of section 501; thus, it is difficult to under-

27. See note 15 & accompanying text *supra*.

28. [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 124-25.

29. 305 U.S. 79 (1938).

30. *Id.* at 83 (footnotes omitted).

31. [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 126. Although Congress considered including laundry services in section 501(e)'s list of exempted activities, Congress expressly declined to do so both in 1968 with the original enactment of the statute and later in 1976. See H.R. REP. NO. 1533, 90th Cong., 2d Sess. 43 (1967); 122 CONG. REC. NO. 1365, S. 13568; S. REP. NO. 94-1236, 94th Cong., 2d Sess. 537 (1976).

32. 158 F. Supp. 560 (Ct. Cl. 1958).

33. See [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 127 (Tannenwald, J., dissenting).

stand how Congress' refusal to include laundry services among the exempt activities of section 501(e) significantly contributes to the validity of a regulation promulgated under section 502.³⁴ Indeed, several courts have found that the exclusion of laundry services from the exempt activities of section 501(e) was not a Congressional statement of policy.³⁵ Judge Tannenwald, in his dissent to the *Associated Hospital* decision, was also troubled by the Tax Court's application of the Reenactment Doctrine, and stated:

It is sufficient to note that Congress was aware, as early as 1967, of the position of [the IRS] and of the Court of Claims decision adverse thereto in *Hospital Bureau* The subsequent legislative history, relating to the enactment of section 501(e), simply articulates the proposition that that section does not exempt cooperative laundry services such as those engaged in by [Associated Hospital Services, Inc.]. Against this background of dual awareness and narrow articulation, I am not convinced that it can fairly be said that the reenactment doctrine should be applied to support [the IRS's] regulation.³⁶

In summary, given the Tax Court's clear reluctance to uphold the validity of the section 502 regulation,³⁷ and given the aforementioned problems with the application of the Reenactment Doctrine to support the validity of that regulation, the IRS's argument that hospital service organizations constitute section 502 feeder organizations is not particularly convincing. Although the IRS won the battle in *Associated Hospital*, it may lose the war should its section 502 regulation be held invalid in future litigation.

2. The Application of Section 502 in *Associated Hospital*

The foregoing discussion of the IRS's section 502 argument has focused on the validity of the third example of the section 502 regulation. The following discussion will focus upon the Tax Court's application of Regulation section 1.502-1(b), to the hospital service organization involved in *Associated Hospital*. Section 502, in pertinent part, provides: "[a]n organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation."³⁸

34. *Id.* at 129 (Wilbur, J., dissenting).

35. See *Northern Cal. Cent. Serv., Inc. v. United States*, 591 F.2d 620 (Ct. Cl. 1979); *Metropolitan Detroit Area Hosp. Serv., Inc. v. United States*, 445 F. Supp. 857 (E.D. Mich. 1978), *appeal docketed*, No. 78-1205 (6th Cir. May 25, 1978) and No. 78-1218 (6th Cir. June 7, 1978); *United Hosp. Serv., Inc. v. United States*, 384 F. Supp. 776 (S.D. Ind. 1974).

36. [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 127 (Tannenwald, J., dissenting).

37. *Id.* at 124-25.

38. I.R.C. § 502(a).

Section 502 and section 1.502-1(b) of the treasury regulations,³⁹ if taken literally, appear to require that a trade or business have at least two characteristics before it will be considered a feeder organization: (1) the organization must generate a profit; and (2) the trade or business must be unrelated to the exempt purpose of the organization to which the profits are paid. With regard to the first characteristic, the Tax Court held in *Associated Hospital* that this apparent requirement is, in fact, not a requirement. Thus, a trade or business can be a feeder organization without generating a profit. The Tax Court stated:

In this context, the words 'for profit' do not establish an independent requirement; they are used in the statute merely to modify the term 'trade or business' to make it clear that a section 502 organization must be a commercial organization rather than an organization operated for an inherently exempt purpose.⁴⁰

Judge Tannenwald clearly disagreed with this reasoning in his dissenting opinion, and stated:

Section 502(a), dealing with the denial of exemptions to feeder organizations, specified '[a]n organization operated for the primary purpose of carrying on a trade or business *for profit*.' (Emphasis added.) As the majority points out, that section was directed against the grant of exemption to a commercial organization merely because its *profit* inured to the benefit of an exempt organization—a situation typified by *C.F. Mueller Co. v. Commissioner* In my opinion, consideration by the Congress of the effect of competition took place within the 'for profit' context.

. . . Although the petitioner herein was carrying on a trade or business, it clearly was not doing so for the primary purpose of profit therefrom. Indeed, as the majority concedes, it was a nonprofit organization and was 'operated in such a way that it realize[d] little or no net income.'⁴¹

Judge Tannenwald seems to have the better view as to the interpretation of "for profit" within the context of section 502. To accept the Tax Court's view that "trade or business for profit" is merely another way of saying "an unrelated trade or business" not only renders the phrase "for profit" meaningless, but also is contrary to the legislative history of section 502. When Congress enacted section 502, it clearly had in mind the situation where a commercial organization gained a tax-exempt status by virtue of paying its profit to another exempt organization.⁴² Thus, Congress contemplated that "profits" meant the generating of revenue beyond operating expenses, with such excess revenues then being paid to an exempt organization.

With regard to the second characteristic, the regulations under

39. See Treas. Reg. § 502(1)(b) (1980).

40. [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 124.

41. *Id.* at 127 (Tannenwald, J., dissenting) (footnotes omitted).

42. *Id.*; *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951).

section 502 provide, in essence, that a subsidiary organization of a tax-exempt organization is not a feeder organization if its activities are substantially related to the exempt purpose of its parent organization.⁴³ The majority decision in *Associated Hospital* failed to address this issue; however, Judge Wilbur's dissent faced the issue and stated that there could hardly be anything more closely related to a hospital's exempt purpose than a bacteria-free laundry.⁴⁴ Also, it should be noted that the courts themselves have consistently held the provision of laundry services to be substantially related to hospital activities.⁴⁵ Since hospital service organizations do not usually have either of the characteristics attributable to feeder organizations, the Tax Court's "feeder organization" rationale is deficient.

B. The Section 501(c)(3) Argument

Just as the enactment of section 501(e) did not stay the IRS's section 502 argument, neither did it stay the section 501(c)(3) argument. With the enactment of the statute, the IRS took the position that hospital service organizations conducting activities other than those specified in section 501(e) were not entitled to tax-exempt treatment under either section 501(e) or section 501(c)(3). The IRS's rationale for its position is that, since section 501(e) specifically addresses tax exemption for hospital service organizations, the general exemption provision of section 501(c)(3) is no longer applicable to such organizations. In short, the IRS argued that

43. The dissent in *Associated Hospital* stated:

Sec. 1.502-1(b), Income Tax Regs., says as much. It notes that a subsidiary organization of a tax-exempt organization can be exempt 'on the ground that its activities are an integral part of the exempt activities of the parent.' It then states: However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business *which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization.* For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt *since such business would be an unrelated trade or business if regularly carried on by the parent organization.*

[1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 128 n.3 (Wilbur, J., dissenting) (emphasis in original).

44. *Id.* at 128 (Wilbur, J., dissenting).

45. See *Northern Cal. Cent. Serv., Inc. v. United States*, 591 F.2d 620 (Ct. Cl. 1979); *HCSC-Laundry v. United States*, 473 F. Supp. 250 (E.D. Pa. 1979), *rev'd*, 624 F.2d 428 (3d Cir. 1980); *Metropolitan Detroit Area Hosp. v. United States*, 445 F. Supp. 857 (E.D. Mich. 1978), *appeal docketed*, No. 78-1205 (6th Cir. May 25, 1978) and No. 78-1218 (6th Cir. June 7, 1978); *United Hosp. Serv., Inc. v. United States*, 384 F. Supp. 776 (S.D. Ind. 1974); *Hospital Bureau of Standards & Supplies, Inc. v. United States*, 158 F. Supp. 560 (Ct. Cl. 1958).

hospital service organizations can only be exempt if they engage exclusively in those activities listed in section 501(e). Prior to the Third Circuit's reversal of *HCSC-Laundry* and the Ninth Circuit's reversal of *Hospital Central Services*, this position had been uniformly rejected by the courts.⁴⁶ The rationale of these courts was that the Congress intended to provide a "safe harbor" tax exemption for hospital service organizations, and thus, section 501(e) broadens the scope of section 501 rather than restricting it in any way. Consequently, hospital service organizations are still entitled to a section 501(c)(3) exemption.

The Tax Court did not take a position on the section 501(c)(3) argument in *Associated Hospital*. The Tax Court merely quoted from *United Hospital Services, Inc. v. United States*,⁴⁷ as follows:

"The clearly expressed Congressional purpose behind the enactment of Section 501(e) was to enlarge the category of charitable organizations under Section 501(a)(3) to include certain cooperative hospital service organizations, and not to narrow or restrict the reach of Section 501(c)(3). The latter section was not modified by the legislation in any way, and the legislation does not purport to take away charitable status from a corporation which had already acquired it. Insofar as this case is concerned, therefore, Section 501(e) is irrelevant."⁴⁸

However, the *HCSC-Laundry* decision clearly addressed the issue.

In *HCSC-Laundry*, the Third Circuit accepted the IRS's section 501(c)(3) argument, and, in doing so, adopted a position contrary to that taken by all other courts which had considered the issue.⁴⁹ The section 501(c)(3) argument was characterized by the Third Circuit as one involving the statutory rule of construction known as *ejusdem generis*, i.e., a specific statute controls over a general statute. Before applying this rule of construction, the Third Circuit noted, by means of a quote from Merten's *The Law of Federal Income Taxation*, that "this rule of *ejusdem generis* is not invariable and should not defeat the legislative intent deducible from the entire context."⁵⁰ Accordingly, the Third Circuit, after conditioning

46. See *Northern Cal. Cent. Serv., Inc. v. United States*, 591 F.2d 620 (Ct. Cl. 1979); *Chart, Inc. v. United States*, 491 F. Supp. 10 (D.D.C. 1979); *Community Hosp. Serv., Inc. v. United States*, 43 A.F.T.R. 2d (P-H) 79-934 (E.D. Mich. 1979), *appeal docketed*, No. 79-1286 (6th Cir. May 29, 1979); *HCSC-Laundry v. United States*, 473 F. Supp. 250 (E.D. Pa. 1979), *rev'd*, 624 F.2d 428 (3rd Cir. 1980); *Metropolitan Detroit Area Hosp. Serv., Inc. v. United States*, 445 F. Supp. 857 (E.D. Mich. 1978), *appeal docketed*, No. 78-1205 (6th Cir. May 25, 1978) and No. 78-1218 (6th Cir. June 7, 1978); *Hospital Cent. Serv. Assoc. v. United States*, 40 A.F.T.R. 2d (P-H) 77-5646 (W.D. Wash. 1977), *rev'd*, 623 F.2d 611 (9th Cir. 1980); *United Hosp. Serv., Inc. v. United States*, 384 F. Supp. 776 (S.D. Ind. 1979).

47. 384 F. Supp. 776 (S.D. Ind. 1974).

48. [1980] TAX CT. REP. DEC. (P-H) ¶ 74-17 at 121.

49. See note 40 & accompanying text *supra*.

50. 624 F.2d 428, 433 (3d Cir. 1980).

the application of the *ejusdem generis* doctrine on the legislative history of section 501(e), proceeded to review such history.

The Third Circuit's review of the legislative history of section 501(e), in large part, did not differ from that set forth above.⁵¹ However, the Third Circuit discounted the significance of the *Hospital Bureau* decision in its analysis of section 501(e) by stating, "[t]hat decision provides little assistance to the statutory analysis we must now undertake when the statute contains the subsequently enacted provision directly applicable to hospital service organizations."⁵² This dismissal of the significance of *Hospital Bureau* in interpreting the later enacted section 501(e) is not shared by others who have considered the issue.⁵³ This is because it is generally felt that Congress was aware of the decision and did not intend to alter it. In *Northern California Central Services, Inc. v. United States*, the Court of Claims reviewed the vitality of its *Hospital Bureau* decision as follows:

In *Hospital Bureau of Standards*, we held that a cooperative hospital purchasing organization serving several non-profit hospitals was exempt from income tax under the predecessor of § 501(c)(3). The Senate Finance Committee, in 1967, mentioned that decision as the 'leading case,' when it attempted to add a provision to the Social Security Amendments of 1967 The Committee reasoned that such a provision [Section 501(e)] was necessary because despite the decision in *Hospital Bureau of Standards*, some hospitals were reluctant to form shared service organizations due to the resistance of the IRS

When Congress passed the present § 501(e) in 1968, though, it did exclude shared laundry services from its list of exempt service organizations, but made no attempt to alter *Hospital Bureau of Standards'* interpretation of § 501(c)(3) or that section's applicability to shared laundry services, despite the fact, above mentioned, that the Congressmen were aware of *Hospital Bureau of Standards*, and its holding.⁵⁴

Besides its dismissal of the significance of the *Hospital Bureau* decision, the Third Circuit's reading of section 501(e)'s legislative history is also questionable on the grounds that section 501(e) was generally thought of as a relief-granting measure, and not as a measure to close a "loop-hole."⁵⁵ Thus, given these two considerations, the doctrine of *ejusdem generis* should not have been applied to defeat the relief-granting intent of Congress.

Even ignoring its questionable reading of section 501(e)'s legis-

51. See notes 14-19 & accompanying text *supra*.

52. 624 F.2d at 435.

53. See *Northern Cal. Cent. Serv., Inc. v. United States*, 591 F.2d 620 (Ct. Cl. 1979); *HCSC-Laundry v. United States*, 473 F. Supp. 250 (E.D. Pa. 1979). See also, *Associated Hosp. Serv., Inc., v. Commissioner*, [1980] TAX CT. REP. DEC. (P-H) ¶ 74.17 at 127 (Tannenwald, J., dissenting); *Id.* at 129 (Wilbur, J., dissenting).

54. 591 F.2d at 624.

55. See 591 F.2d 620 (Ct. Cl. 1979). See also note 39 & accompanying text *supra*.

lative history, the Third Circuit's reversal of *HCSC-Laundry* is also troublesome because its holding appears to be based upon circular reasoning. The Third Circuit stated:

We believe that it [section 501(e)'s legislative history] demonstrates that Congress recognized that hospital service organizations were not heretofore encompassed within section 501(c), or that their inclusion within that section was questionable. . . . If they [the hospital service organizations] had already been within section 501(c), the enactment of section 501(e) would have been a totally superfluous undertaking by Congress, an anomalous result which we cannot attribute to it.⁵⁶

As noted above, the Third Circuit's holding was originally premised on the statutory rule of *ejusdem generis*, and thus was conditional upon an analysis of legislative history. Yet the Third Circuit then attempted, as the above quote demonstrates, to justify its reading of the legislative history by applying the statutory rule of *ejusdem generis* (i.e., that the specific section 501(e) must control the general section 501(c)(3)). Therefore, the Third Circuit's rationale can be criticized as being circular.

The Ninth Circuit also recently considered the section 501(c)(3) argument. In *Hospital Central Services Association v. United States*, the Ninth Circuit reversed a district court decision and tersely adopted the view and reasoning of the Third Circuit in *HCSC-Laundry*.⁵⁷ The entire substance of the decision in *Hospital Central Services* is reflected in the fifth and final paragraph of the opinion:

Whether the legislative decision to favor the commercial laundry industry by removing a tax advantage from competitors was a wise or equitable decision is obviously not a judicial question. On the only judicial question—the meaning of the tax law—we agree with the Third Circuit for the reasons stated in its opinion.⁵⁸

In comparison with the decisions of the Tax Court and the Third Circuit, it is clear that *Hospital Central Services* offers little to the resolution of the hospital service organization controversy, and, for the reasons already discussed,⁵⁹ the merit of the decision is questionable.

IV. CONCLUSION

The decisions in *Associated Hospital, HCSC-Laundry* and *Hospital Central Services*, are the first taxpayer defeats in the hospital service organization controversy. As indicated above, however, these decisions' holdings were reached through challengeable anal-

56. See 624 F.2d 428, 436 (3d Cir. 1980), *rev'g* 473 F. Supp. 250 (E.D. Pa. 1979).

57. 623 F.2d 611 (9th Cir. 1980), *rev'g*, 40 A.F.T.R. 2d (P-H) 77-5646 (W.D. Wash. 1977).

58. 623 F.2d at 612.

59. See notes 43-49 & accompanying text *supra*.

ysis. Also, the holdings in all three of these cases might be limited to their facts because these cases involved hospital service organizations which only provided laundry services. Although the holdings of the Tax Court and the Courts of Appeal were different, the critical factor to each of the courts was the fact that Congress had clearly considered laundry services and had chosen to exclude them from the exempt activities permitted by section 501(e). Thus, it is arguable that the holdings should apply only to hospital service organizations which provide laundry services. This is particularly true of the decision in *Associated Hospital*. Unfortunately, the holding of *HCSC-Laundry* and *Hospital Central Services* is broad enough to apply to any hospital service organization which provides any service not expressly provided for in section 501(e). Therefore, the appeal presently pending in the Sixth Circuit with regard to the hospital service organizations should be closely followed. Should a conflict of the Circuits develop, the prospect of the Supreme Court settling the controversy is certainly a probability, particularly if Congress fails to act.